Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Simplification of the Depreciation Prescription Process	)	CC Docket No. 92-296
	)	
	)	

ERRATUM TO COMMENTS OF
BELLSOUTH TELECOMMUNICATIONS, INC.

BellSouth Telecommunications, Inc. ("BellSouth") hereby files this Erratum to its Comments filed in the referenced docket on March 10, 1993. BellSouth seeks to supplement its Comments as page 14 of the Comments was inadvertently omitted. BellSouth hereby submits a complete copy of its Comments.

Respectfully submitted,

BELLSOUTH TELECOMMUNICATIONS, INC.

By its Attorneys:

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March 17, 1993

CERTIFICATE OF SERVICE

I hereby certify that I have this 17th day of March, 1993 serviced all parties to this action with a copy of the foregoing ERRATUM TO COMMENTS by placing a true and correct copy of same in the United States mail, postage prepaid, addressed to:

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Susan Queen
Susan Queen

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COMMENTS OF BELLSOUTH TELECOMMUNICATIONS, INC.

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BELLSOUTH TELECOMMUNICATIONS, INC.

DATE: March 10, 1993

SUMMARY

BellSouth strongly endorses the Commission's initiative to reform the depreciation represcription process. BellSouth endorses the Price Cap Carrier Option, with modifications, to determine the appropriate depreciation of interstate assets of the price cap LECs. BellSouth provides secondary support for the depreciation rate range option.

Implicit in traditional regulation of depreciation is an assumption that present and future assets will have lives similar to former assets. Historical mortality data therefore is given great weight in estimating the remaining lives of assets. That assumption is no longer sound because it gives inadequate consideration to technological obsolescence and competitive necessity. There is no precision to the current process, and regulators should not pretend otherwise.

Excessive reliance on historical data has resulted in inadequate depreciation rates and resulting depreciation reserve deficiencies. The Commission has recognized the existence of depreciation reserve deficiencies in the past, and has taken steps to amortize those deficiencies. It has also adopted new depreciation methods designed to provide more timely capital recovery. Unfortunately, even with these revisions, depreciation rates remain inadequate to provide timely capital recovery, especially in the accounts most effected by technological advances.

An explosion of new technology and increasing competition characterize today's telecommunications industry. Under such conditions, the existing depreciation process defers capital recovery to the latter stages of asset life cycles. Deferred capital recovery adversely effects capital costs, cash flow, infrastructure development, and competition. It also is discriminatory, in that it causes the cost of assets used to provide service to today's customers to be borne by tomorrow's customers. It is critical for the Commission to address the flaws in the present regulation of depreciation if its infrastructure development and competition initiatives are to succeed.

impact on customer rates. Under price cap regulation, the link between depreciation expense and customer rates is broken. Carriers can be allowed much greater flexibility to set their own depreciation rates, based on their best judgment as to the remaining lives of their assets, without adverse impact on customers. In these comments, BellSouth offers a specific blueprint for the design of a price cap carrier option that will result in more accurate depreciation, while retaining adequate consumer safeguards.

The BellSouth proposal will result in an open represcription process in which all interested parties will be able to participate in a meaningful fashion. The Commission will simply accord more weight to the views of carrier management regarding the future remaining lives of the carrier's depreciable assets. The Commission retains the right and the responsibility to investigate questionable filings. Any attempt by a carrier to "manipulate" depreciation rates will be easily identifiable and subject to correction by the Commission.

BellSouth's proposal is entirely consistent with the Commission's obligations under Sections 220(b) and 220(i) of the Communications Act. It will insure reasonable depreciation rates for the interstate operations of price cap carriers.

BellSouth agrees with Commissioner Duggan that accurate depreciation is essential. Unfortunately, the present

process has not resulted in accurate depreciation. BellSouth proposes modifications to the price cap carrier option that fully address the concerns expressed by Commissioner Duggan in his concurring statement to the NPRM.

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COMMENTS OF BELLSOUTH TELECOMMUNICATIONS, INC.

BellSouth Telecommunications, Inc. ("BellSouth") offers the following comments on the Commission's proposal to simplify the depreciation prescription process, as proposed in the Notice of Proposed Rulemaking ("NPRM"), FCC 92-537, released December 29, 1992. As set forth below, BellSouth supports Option D, The Price Cap Carrier Option, for those carriers, such as BellSouth, whose interstate services are subject to price cap regulation.

I. Introduction

BellSouth commends the Commission for seeking ways to simplify the process and procedures to determine the appropriate depreciation of assets used to provide interstate telecommunications services. As shown below, insufficient capital recovery is a significant and continuing problem. Most importantly, depreciation reform can be undertaken at this time with no adverse impact on customers. Nor will depreciation reform hamper the ability of the Commission to evaluate the performance of price cap regulation of local exchange carriers ("LECs").

A. Depreciation Accounting.

Depreciation is the process by which the cost of depreciable assets[1] are assigned to periods of time during which these assets are used to provide service.[2] Each accounting period bears its appropriate "depreciation expense", with an equal, offsetting amount credited to an accumulated depreciation "reserve" account.[3] Capital recovery occurs when revenue is received to recover the depreciation expense charged to a particular time period. When the asset is removed from service (retired), its original cost, less the cost of removal and salvage value, is deducted from the telephone plant in service account and the depreciation reserve account.

The Supreme Court described the role of depreciation in public utility regulation as follows:

> Depreciation is defined as the loss in service value of a capital asset over time. In the context of public utility accounting and regulation, it is a process of charging the cost of depreciable property adjusted for net salvage, to operating expense accounts over the useful life

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[1]Depreciable assets are those assets whose costs are capitalized. Assets whose useful life is indefinite, e.g., land, are not depreciated. Some assets, such as furniture, have a cost floor, e.g., $500, which must be exceeded for an item to be capitalized and depreciated. Items whose costs are below the floor are expensed.

[2]The Commission's full definition of depreciation is found in Section 32.9000 of the Rules.

[3]Credits to the accumulated depreciation accounts are called "depreciation accruals". Under Part 32 of the Commission's Rules, accumulated depreciation and amortizations are recorded in Accounts 32.3000, et seq.

> of the asset. Thus, accounting practices significantly affect, among other things, the rates that customers pay for service. This is so because a regulated carrier is entitled to recover its reasonable expenses and a fair return on its investment through the rates it charges its customers, and because depreciation practices contribute importantly to the calculation of both the carrier's investment and its expenses. (Citations omitted).
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> The total amount that a carrier is entitled to charge for services, its "revenue requirement," is the sum of its current operating expenses, including taxes and depreciation expenses, and a return on its investment "rate base." The original cost of a given item of equipment enters the rate base when that item enters service. As it depreciates over time--as a function of wear and tear or technological obsolescence--the rate base is reduced according to a depreciation schedule that is based on an estimate of the item's expected useful life. Each year the amount that is removed from the rate base is included as an operating expense.[4]

Because the number of items of depreciable plant owned by telephone companies is so large, the Commission permits investment to be grouped for depreciation purposes. Since 1980, the Commission has prescribed the use of the Straight Line Equal Life Group ("ELG") method of depreciation. The Commission also employs "remaining life" procedures to insure that 100 percent of the original investment is recognized over the useful life of the investment.

Although these revisions represent significant improvements over prior methods, setting depreciation rates

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[4] Louisiana Public Service Commission v. FCC, 476 U.S. 355, 364-365 (1986).

remains an inexact art, at best.[5] The reason can be seen by reviewing the four factors that go into computing depreciation rates: the original cost of a depreciable asset, the remaining life of that asset, the cost of removing the asset from service at the end of its useful life, and the salvage value received upon disposition of the asset.[6] Of these four items, only one is certain--the original cost of the asset. Each of the remaining three items must be forecast. As the Commission noted in 1987:

> The straight-line depreciation rate is a function of an asset's service life, which must be forecast. Because of the multitude of factors which affect the service life of an asset, it is very difficult to forecast accurate service lives, especially for new assets. As a result, an important part of the depreciation rate setting process is the periodic review of the life forecasts as better and more detailed information becomes available. As that new information becomes available, it is essential that new rates be determined and promptly applied, so that accurate depreciation expenses can be booked and depreciation reserve imbalances can be avoided.[7]

A depreciation reserve imbalance occurs when the book reserve (the amount that has accumulated in the reserve

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[5]The Commission has recognized that depreciation rate determinations are imprecise. See Property Depreciation, 83 FCC 2d 267, 270-271 (1980).

[6]The Commission uses the following formula to determine depreciation rates:

$$\text{dep. rate} = \frac{100\% - \text{accumulated dep.}\% - \text{future net salvage}\%}{\text{average remaining life}}$$

[7]In the Matter of Amortization of Depreciation Reserve Imbalances of Local Exchange Carriers, 2 FCC Rcd 6473 (1987), at para. 3.

account on the company's books) deviates from the theoretical reserve, or reserve requirement. The theoretical reserve is the amount the reserve should be, if the service life and associated parameters were forecast accurately. When the book reserve is less than the theoretical reserve, a depreciation reserve deficiency exists. The Commission described the process by which a reserve deficiency occurs as follows:

> [W]hen plant retires under group depreciation, its original cost is subtracted both from plant in service and from the depreciation reserve. If the retirement occurs at the end of the forecast service life, the accumulation of the depreciation expenses associated with the plant will match the amount to be subtracted from the reserve when the plant is retired (i.e., its original cost), and thus, the retirement will have no lasting effect on the depreciation reserve. If the retirement occurs long before the original projected service life has expired, the full original cost of the plant is still subtracted from plant in service and from the depreciation reserve. In this case, however, the plant's contribution to the depreciation reserve (i.e., the accumulation of annual depreciation expenses) is less than what it withdrew with its retirement, and its retirement may create a depreciation reserve imbalance.[8]

noted above, in times of rapid technological change, prescribed depreciation lives may be longer than the economic life of the assets, due to obsolescence. If prescribed lives are too long, these methods may delay recognition of depreciation to the latter stages of the asset's life cycle, thereby creating a depreciation reserve deficiency. The Commission's staff conducted a comprehensive study of the depreciation reserve imbalance of the domestic telecommunications industry, including AT&T, in

> While in theory [remaining life and ELG] permit more timely capital recovery, they suffer from the deficiency of placing a large portion of the burden of recovery well into the future at the end of the product or service life cycle. Unfortunately, this is precisely the time at which recovery of a disproportionate share of depreciation expenses will be the most difficult, because telephone companies will then have limited pricing flexibility in the face of potentially lower cost and more advanced competitive offerings.
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> . . .
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> A competitive market will not allow overestimation of plant lives and consequent capital recovery shortfalls to be corrected by future increases in service prices. Continuation of current practices is a prescription for disaster.[11]

In order to address the $13 billion reserve deficiency calculated by the Commission staff in 1987, the Commission authorized a one-time, five year amortization of the industry's reserve deficiency.[12] While that amortization eased the historical imbalance that existed at that time, it did not prevent the problem from recurring. A number of current studies show that the problem of inadequate capital recovery remains a substantial burden to the LEC industry. That burden takes on significant policy implications when assessing the state of the telecommunications infrastructure in this country.

In October, 1991, the National Telecommunications and Information Administration of the U.S. Department of

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[11]Fogarty, "Capital Recovery: A Crisis for Telephone Companies, a Dilemma for Regulators", Public Utility Fortnightly, December 9, 1983, pages 14-15, 17.

[12]In the Matter of Amortization of Reserve Imbalances of Local Exchange Carriers, 3 FCC Rcd 984 (1988).

Commerce released "The NTIA Infrastructure Report: Telecommunications in the Age of Information" ("NTIA Report"). With regard to current depreciation practices, the NTIA Report found:

> Adherence to historical depreciation practice in the face of rapid technological change has meant that the investment assets on regulated firms' books of account are consistently, and in many cases, substantially overvalued. For monopoly firms under rate of return regulation such practices may hinder efficient investment in new technologies and services, while restraining rates below their efficient levels. When competition develops, the overvaluation of the assets of such firms presents the following dilemma: If rates are set at accounting costs (including the costs of the overvalued assets), the firms may not be able to compete with rivals using more modern, lower cost technologies. If, however, rates are set to reflect economic costs (including the "true" value of the overvalued assets), firms under traditional rate of return regulation may not be able to generate sufficient revenues to recover the costs of their investments. Because of the problems stemming from traditional depreciation practices, many commenters in this proceeding have emphasized the need for fundamental changes in those procedures.[13]

The NTIA Report cautions against adopting depreciation reform that is not sufficiently flexible to adapt to rapidly changing conditions:

> [A]lthough adequate depreciation will mitigate the risks of non-recovery, there will always be some uncertainty about what constitutes an "adequate" depreciation rate, even if that figure is selected by the firm itself. Technological change and increased competition may quickly turn a depreciation plan that appeared reasonable when adopted into one that does not permit full recovery of the costs of the investments made. In other words, there is always some risk of non-

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[13]NTIA Report at 255.

> recovery. While aligning an investment's "useful" life more closely with its economic life will diminish that risk, depreciation plans should be flexible enough to permit the firm to adjust to changing conditions in order to insure recovery.[14]

More recently, a major study of the telecommunications infrastructure was undertaken by the Center for Telecommunications Management of the University of Southern California. The resulting report was published on January 6, 1993 as "Telecommunications Infrastructure Policy and Performance: A Global Perspective" ("CTM Report").[15] With regard to current capital recovery policies, the CTM Report found:

> Furthermore, capital recovery (depreciation) trends in the U.S. show a shocking pattern. During this remarkable period of rapid technological progress and obsolescence, asset lives for public network equipment of local exchange companies have actually increased in the U.S.. Nations like Japan, U.K., Singapore and others write off and replace equipment twice as fast as most U.S. carriers. Regulatory oversight of asset lives in the U.S. appears to be the primary cause of this problem.

In what could be the equivalent of the "arms race"

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[14]NTIA Report at 256.

[15]As noted in the foreword to the CTM Report:

> CTM was fortunate to have this research sponsored and guided by a broad range of industry participants, from service providers and equipment manufacturers to consumer advocates, regulators and industry consultants. The project Advisory Board provided many valuable contributions from helping to shape the scope and structure of the research, to support in the data gathering process and review of the final report. CTM Report at 1-1.

for the next generation, the U.S. track record is not encouraging.[16]

The outlook is particularly bleak in the so-called "technology accounts". The CTM report compared the 1991 prescribed asset lives of Bell companies, independent LECs and U.S. interexchange carriers with the asset lives of major foreign telecommunications providers, including those in France and Japan, in digital switches, fiber cable and copper cable. The differences were astounding:

1991 COMPARATIVE ASSET LIVES

Type of Carrier	Digital Switches	Fiber Cable	Copper Cable
U.S. RBOCs	19.14 years	30.43 years	23.18 years
U.S. Ind. LECs	14.55 years	22.56 years	25.03 years
U.S. IXCs	9.23 years	16.12 years	10.90 years*
France	10.00 years	10.00 years	15.00 years
Japan	6.00 years	10.00 years	6.00 years

*1991 data not available, 1988 lives used.

(Source: CTM Report, Tables 5.4, 5.7, 5.8 and 5.9)

The CTM Report also looked at the depreciation of fiber cable by cable television companies and the depreciation of digital switches by U.S. cellular carriers. Fiber cable is depreciated over 5 to 15 years by U.S. cable companies. The average asset life for digital switches by U.S. cellular carriers was 8.8 years.[17]

From these statistics, the CTM Report drew the following conclusions:

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[16]CTM Report at 2-3.

[17]CTM Report at 5-23.

> U.S. policy makers interested in building up the nation's telecommunications infrastructure should note these trends. The data in this report clearly indicates a correlation between faster capital recovery and aggressive capital investments, and a dramatic shortening of asset lives among the telephone companies in other countries. These are ominous signals to regulators who are lengthening those lives. The outlook for U.S. local exchange companies is for increasing reserve deficiencies and growing difficulties in justifying necessary network upgrades to shareholders and regulators. The short asset lives of unregulated communications companies in the U.S. make it clear that regulators hold the key to resolving this problem. Policy makers who want to increase investments in the nation's telecommunications infrastructure should make regulatory reform of capital recovery rates an integral part of their effort.[18]

The problem with existing procedures is twofold: the natural desire on the part of regulators to hold down current customer rates by deferring capital recovery; and depreciation analysts' primary reliance on historical mortality data to estimate future asset lives.

The first problem results from viewing capital recovery as a "rates" issue rather than a "policy" issue. This overlooks the fact that there are significant policy issues involved in depreciation regulation: infrastructure development, efficient utilization of resources, efficient prices that foster true economic competition, and distortion of reported earnings, to mention just a few. As discussed in more detail in Part II of these comments, under price cap regulation the "rates" issue becomes immaterial relative to

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[18]CTM Report at 5-24.

the "policy" issues.

The second problem, excessive reliance on historical

places heavy emphasis on historical accounting information. For example, under the current process, BellSouth must file between 3000 and 4000 sheets of accounting details on a vintage level basis. Much of this data is on accounts that cumulatively involve only one to three percent of BellSouth's total investment. BellSouth and other carriers spend months researching immaterial historical adjustments to prepare for the Commission's three-way meetings. The current process is a costly, tedious one that usually results in a very small percent change in depreciation accruals.

For example, BellSouth's depreciation rates were represcribed in the Southern Bell states in 1989 and 1992, and in the South Central Bell states in 1990. The accrual changes resulting from the triennial review process, using the Commission's basis and combined numbers, were as follows:

Year	Accrual-Old	Accrual-Represcribed	Percent Change
1989	$1.376 B	$1.436 B	4 percent
1990	$1.033 B	$1.067 B	3 percent
1992	$$1.435 B	$1.513 B	5 percent

The review process focuses primarily on historical retirement patterns. Insufficient weight is given to the effect of competition and technological obsolescence on plant lives. The result has been deferred depreciation.

As a result of Commission depreciation practices,

[redacted]

interexchange market. For example, at divestiture, AT&T wrote down for financial reporting purposes (but not for regulatory reporting purposes) some $7.3 billion, primarily its investment in the embedded base of CPE equipment that was assigned to it by the divestiture court.[23] In 1988, AT&T took a pretax charge of $6.7 billion, for financial reporting purposes only, relating to analog equipment that had become technologically obsolete.[24] MCI took a pretax charge of $550 million in 1990 to recognize the early obsolescence of microwave transmission equipment and to speed up the conversion of its network to digital technology.[25] Increasing competition and technological obsolescence could impair the assets of LECs in the future if steps are not taken now to permit timely recovery of invested capital.

D. A simplified depreciation prescription process must provide carriers with increased control over depreciation rates.

The Commission treats depreciation rate represcriptions as an endogenous cost for price cap carriers on the theory that the carriers control both their investments and their retirements. This implies that they also control their

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[23]"Wrong Number: AT&T's Earnings Shocker and What it Means", Barron's, October 24, 1983, at page 15.

[24]"AT&T to Take a $6.7 Billion Charge in Period", The Wall Street Journal, December 12, 1988.

[25]"MCI Posts Loss of $176 Million; Charge is Cited", The Wall Street Journal, October 18, 1990.

depreciation expense. The Commission has recognized, however, that this is at best only partially true, since the Commission continues to prescribe the depreciation rates of price cap carriers based on the Commission's view of the remaining lives of carriers' assets.[26]

In early 1988, when the Commission was considering the adoption of price cap regulation, BellSouth proposed that the Commission give price cap carriers the responsibility for establishing their own depreciation rates. BellSouth proposed specific rules to implement that option in a manner consistent with the Commission's responsibilities under the Communications Act. BellSouth proposed that depreciation expense be considered endogenous under price cap regulation if its proposal was adopted.[27]

In 1989, the Commission decided to treat depreciation expense as endogenous, but it declined to consider revisions to its depreciation prescription process that would truly give carriers responsibility and control over their depreciation expenses.[28] In the ensuing years, the

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[26]In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Report and Order and Second Further Notice of Proposed Rulemaking, FCC No. 98-91, released April 17, 1989, paras. 290-291. See also, Id., Second Report and Order, FCC No. 90-314, released October 4, 1990, paras. 183-184.

[27]BellSouth Corporation, Rules Submissions, CC Docket No. 87-313, filed January 27, 1988.

[28]In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Report and Order, FCC No. 98-91, released April 17, 1989, para. 293.